Auditors and the Permissive Society: Market Failure, Globalisation and Financial Regulation in the US.[1]

Introduction

On 2 December 2001, Enron, the Houston based energy trading company, filed for bankruptcy protection. The nature and scale of Enron's bankruptcy was, at the time, unprecedented. Enron had come into existence in 1985 as the product of a merger between two gas pipeline companies. Massive debts initially held back growth in the new company. But a decision to transform the business into a financial institution in the late 1980s provided a substantial lift to the company's earnings which was soon reflected in an extraordinary rise in the price of its shares (Fox, 2002; Bratton, 2002). Between January 1991 and January 1993, Enron's stock rose 75 *per cent*, and before 1993 had run its course, Enron's stock rose above $50 a share for the first time (Fox, 2002: 47). By August 2000, when Enron's stock reached a high of $90.75, the company was the seventh largest in the US by market capitalisation (Staff to the Senate Committee on Governmental Affairs, 2002: 72). Not only, however, had Enron become one of the US's leading corporations, it had also developed a reputation 'as America's corporate shock troop' for urging 'radical reliance on market discipline' and the dismantling the New Deal regulatory legacy (Bratton, 2002: 7 and 17; *Business Week*, December 2001). The combined effect of the rapid growth of the company and its success in driving back the boundaries of federal and state regulation led Fortune Magazine to rank Enron as the country's most innovative for six years and probably explains why its CEO, Jeff Skilling, was voted the second best chief executive in the US in August 2001. Despite these plaudits, however, Enron's status as a symbol of the confidence of US corporations in the late twentieth century was brief. By the end of September 2001, the company's shares were quoted at just $25. Exactly a month later they were trading at $13.90 and, by the end of the next month, on November 30th, they were quoted at 26 cents (Bratton, 2002: 41-42). Two days later the company filed for bankruptcy protection.

Not only was the loss of shareholder equity, in excess of $60 billion (Fox, 2002: 264), immense, but, with assets of $62 billion, Enron was also the largest company to declare bankruptcy protection in US history (Staff to the Senate Committee on Governmental Affairs, 2002: 71; Ribstein, 2002). Over the months that followed the full extent of the company's attempts to manage its earnings, still the best explanation for both the spectacular rise and sharp decline in its fortunes (Bratton, 2002: 22-54), became apparent. Put simply, from 1997 Enron fraudulently managed its reported accounts to make it look like the company had more revenue and earnings, less debt and greater operating cash flow (Powers et al, 2002; Bratton, 2002). The sums involved in some of the accounting schemes were, like the decline in the company's share price and its bankruptcy, huge. For example, Enron's attempts to disguise loans as commodity trades accounted for an estimated $7-8 billion in what have been alleged to be improperly recorded liabilities and cash flow.[2] Likewise, when Enron restated its earnings for the period 1997 to 2001 to bring a number of hitherto concealed subsidiaries back on to the company's consolidated accounts, the effect was to reduce reported net income by $586 million (or 20 *per cent* of its earnings for the period) and increase reported debt by a massive $2.6 billion (Fox, 2002: 275-277). But although the sums involved in Enron's false accounting were vast, the loss of shareholder equity breath-taking and the company's bankruptcy unprecedented, Enron was not, in the event, exceptional (Ribstein, 2002: 8).

On the contrary, five of the largest bankruptcies in US history (including Enron) occurred in 2002 (*The Guardian*, 19 December 2002). Moreover, other large frauds at other large companies were discovered soon after as was the need for several major companies to restate their accounts. These included the telecommunications companies Global Crossing, Qwest Communications and Worldcom (which quickly surpassed Enron as the largest bankruptcy in US history), as well as Tyco International, Adelphia, Dynergy, Rite-Aid and Xerox. More interestingly perhaps, Enron's fall was immediately preceded by a host of other cases such as Sunbeam, Cendant and Waste Management, all of which had involved massive frauds and accounting restatements. The simple fact was that corporate America had been laid waste by deception, false accounting and bankruptcy. This fact (and the fact that in many cases these frauds were not so deeply embedded within the corporations concerned or so complex that the deceptions could not have been uncovered long before they actually emerged)[3] imposed some important constraints on the political debate that followed. Put simply, it became very difficult for those unsympathetic to reform to argue that the regulatory failure involved was an isolated fault of an otherwise reliable system. This was especially true given that in most cases the institutions with formal responsibility for regulating the capital markets either did not discover the frauds or did not report them to the Securities and Exchange Commission (SEC), the lead regulatory body in the US (Ribstein, 2002). Not only, in short, did the watchdogs not bark, but their collective silence suggested systemic failure (Healy and Palepu, 2002; Bratton, 2002: 59-62; Staff to the Senate Committee on Governmental Affairs, 2002: 2). The key question, of course, is why?

The following analysis aims to address this question as part of a wider discussion which asks whether the internationalisation of the world's capital markets (and the attendant massive expansion in the movement of capital), so often the cause of disabling financial disasters (Bello et. al, 2000), helps us to make sense of this regulatory failure. The basic conclusion of the analysis is that, in many important respects, it does not. More specifically, while there is some, quite persuasive, evidence to suggest that liberalisation of capital flows is deeply implicated in the emergence of what a former chair of the SEC once described as the 'numbers' game' (and, therefore, by implication in many of the recent cases of accounting fraud), it does not really help us to understand why there was such a complete failure in the SEC's ability to anticipate and prevent such a large number of huge corporate frauds (Doug, 1997; Levitt, 1998). Instead, this paper contends that to understand most of the recent examples of regulatory failure we need to focus, in the first instance, on the structure of the current system of financial regulation in the US (which was forged long before the present liberalisation of the world's capital markets) and the domestic political context in which it operates. Only then should we look at the greater economic uncertainties and more acute competitive pressures that tend to characterise the current system of globalised finance. The main focus of the analysis is on the accounting profession since this, arguably, represents the most independent of the private institutions responsible for fraud surveillance (see below). The discussion begins with a brief summary of the structure of financial regulation in the US. There then follows a section that looks at the limits to detecting corporate fraud through auditing. The final part of the discussion attempts to explain these limits in terms of the historical development of the accounting profession, the legal context in which it operates, and the uneven nature of 'corporate colonisation' in US government and financial regulation (Bloggs, 2000).

Accounting for Growth: Corporations, Audits and Financial Reporting

Financial Regulation: A Public-Private Partnership?

The system of financial regulation in the US is based on a two-tier system of control. This comprises the SEC, on the one hand, and a range of unrelated private institutions, on the other. In principle, these private institutions – which include non-executive directors, investment banking firms, commercial lawyers, security analysts, credit rating agencies and auditors – are expected to work in partnership with the SEC to regulate the US's vast capital markets. In some respects they are of secondary importance to the SEC which (in addition to being responsible for enforcement) performs what is, in effect, a supervisory role, issuing rules and guidance to regulated corporations as well as to other organisations involved in financial regulation. In other respects, however, particularly fraud surveillance, they play a far more important role than the SEC. This is because, with approximately only 3000 employees, the SEC is simply not adequately organised or funded for the purposes of reviewing, inspecting and analysing corporations and their accounts. Its role, in fraud surveillance and detection at least, is, therefore, peripheral, leaving the actual practice of uncovering corporate fraud to private institutions like securities analysts and investment banks (Staff to the Senate Committee on Governmental Affairs, 2002: 1-2; 8-18).

It is this basic premise of financial regulation in the US – that the detection of fraud can be left to private commercial organisations that are neither positioned nor organisationally motivated to uncover fraud – which ultimately explains the regulatory failure in the US. Certainly, in light of recent events, the assumption that securities analysts or investment banking firms might perform a major role in fraud detection now seems perverse. At the very least, it is an assumption that seems to be distinguished by its refusal to recognise the real nature and strategic position of these institutions relative to the corporations that they are ostensibly meant to regulate (ibid). The same argument, however, cannot be so easily made about auditors. On the contrary, the requirement that company accounts are externally audited to ensure that public companies prepare financial statements in accordance with Generally Accepted Accounting Principles (GAAP) and the securities laws in the US[4] seems to represent an important layer of fraud surveillance. This, at least, is the broad effect of the Securities Exchange Act, which assumes that auditors will detect fraud and report their suspicions either to the company board or the SEC. It was also understood as a basic component of the auditor's role in the Supreme Court decision of *United States v Arthur Young & Co.* which held that auditors owe 'ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public'. The audit process, therefore, appears to be qualitatively distinct from investment banking, credit rating or the analysis of securities in that the essence of the enterprise is characterised by a legal duty which not only implies that the auditing firm has 'total independence from the client', but which also suggests that audit firms assume 'a public responsibility transcending any employment relationship with the client'.[5]

On closer inspection, however, there is less to distinguish auditors from the SEC's other private sector regulatory partners than might first appear. In fact, both the assumption of independence and the idea that auditors might play an active role in the detection of corporate fraud seems to be based on a poor understanding of the basic conflict of interest that characterises the relationship between auditor and audit client, wishful disregard for how the evolution of accounting firms into multi-disciplinary commercial organisations has compounded this conflict of interest and an unwillingness to come to terms with the prevailing organisational culture of auditing firms.

The Independent Auditor?

An audit firm's capacity to ensure that its client complies with GAAP - as well as its ability to make certain that the firm itself discharges its responsibilities to the company's shareholders and creditors – is dependent on two related factors. The first concerns the auditor's independence from the corporate client, whilst the second concerns its capacity to unearth questionable accounting methods. Auditors, in other words, must be able to access and understand the unprocessed data upon which a company has based its accounts and, just as importantly, be able to object if the company's calculations are misleading or in violation of GAAP. Both are compromised by the fundamental tension that all auditors necessarily face. This arises because neither existing nor prospective corporate creditors and shareholders (which the decision of the Supreme Court in *Arthur Young* assumed the audit firm owes primary allegiance) pay for the audit. The effect is that the auditors' independence, as well as its ability to demand the production and satisfactory explanation of basic commercial and financial data, is potentially undermined 'simply by accepting [the] audit engagement' (O'Connor, 2002: 2) since future income from auditing is dependent on the renewal of existing contracts for service.

Independence and the Multidisciplinary Professional Service Organisation

This basic conflict of interest seems important to understanding accountants' traditional failure to prevent corporate fraud because it appears to privilege the development of a conciliatory, rather than adversarial, relationship between a corporate client and its auditor. However, it is important not to overstate the structural constraints that the audit-client relationship imposes on auditor independence. This is because, once contracted, an audit firm is very difficult to dismiss. Corporations in the US are now required to formally disclose that the contract with their auditor has been terminated which inevitability invites greater scrutiny and can potentially bring into question the veracity of the corporation's accounts. Thus, there exist important disincentives that operate to deter corporations from exploiting the basic conflict of interest that characterises the auditor-client relationship (Gordon, 2002: 6-7).

In many respects, however, these disincentives (insofar as they exist) have been neutralised as audit firms have evolved into multi-disciplinary professional service organisations with audit, tax and consulting divisions. Quite how this has occurred will be considered below, but for the present it is important to appreciate the extent of this important transformation. In the mid 1970s, the Federal Trade Commission, concerned about the emergence of a potential oligopoly by the large accounting firms, required the profession to change its standards to allow audit firms to advertise and compete aggressively with each other for clients. Audit firms responded by competing on price, focusing on cost cutting and, importantly, expanding into new areas (Healy and Palepu, 2002: 19). By the beginning of the current decade (before the major accounting firms began to divest themselves of their consulting businesses) the consulting divisions of the major accounting firms offered a wide variety of services, ranging from corporate finance to factory automation (O'Connor, 2002: 53-62; *Wall Street Journal*, 6 February 2002). More importantly, because revenue from auditing among the large accounting firms remained relatively constant during the 1990s, expansion became dependant on increasing revenue from non-audit work. Audit firms, like Andersen, began to encourage growth of the business by persuading partners to sell non-audit services to audit clients and linking the remuneration of partners to their generation of new business. Non-audit work proliferated. By 1999, only \$9.5 billion, or 37 *per cent*, of the combined revenue of the five largest accounting firms in the US (\$26 billion) was attributable to accounting (Coffee Jr., 2001: 14).

This relative decline in audit revenue and the related transformation in the nature of the accounting business had three important related effects. The first, and arguably most important effect, as indicated above, has been to neutralise the risks associated with controlling an audit firm through the potential, implied or explicit threat of dismissal. The cross selling of consulting services has given corporations an alternative means of exercising control over the audit process. Not only has it meant that more revenue is at risk when an audit firm objects to a company's figures, but it is also the case that the audited corporation can exert commercial pressure on the audit firm - by threatening to withhold, not renew or not seek consulting services – without the risk of formal public disclosure (Gordon, 2002: 6-7). The diversification of accounting firms, in other words, has created an opportunity for corporations to manipulate and control their auditors without risk of greater public scrutiny.

Poor performing audit revenue and the related shift in focus of accounting business also led to a deterioration in the quality of audits. This was, in part, because audit firms began to develop standard operating procedures so that variation in audit quality could be reduced, costs lowered and the risk of litigation minimised. Auditing, in short, became commodified. And, as firms attempted to maximise declining audit revenue through higher volumes whilst at the same time offering audit services at marginal or below cost (to facilitate business relationships with companies in the hope that this would lead to highly profitable consulting contracts), the quality of audits deteriorated. This decline in quality intensified as a result of changes to both the remuneration of accountants and the basic form of accounting standards. Remuneration and promotion became more closely linked to attracting new audit clients and retaining existing ones. This tended to place a premium on good relationships with top management, rather than professional integrity or technical expertise, and had the effect of discouraging adversarial auditors and, therefore, adversarial audits. Changes in the basic form of accounting standards tended to facilitate this process. Large accounting firms persistently lobbied for more particularistic accounting standards to make it easier for them to verify that their clients' financial reports satisfied GAAP . This was aimed at reducing the risk of litigation. However, it also made it possible for balance sheets to become disaggregated, allowing each successive transaction to be assessed against GAAP in isolation. Auditing, as such, became a more perfunctory exercise, less forensic based more concerned with audit rules and less concerned with the relationship between financial transactions and the fundamental value of the audited company (Healy and Palepu, 2002: 19-20; Staff to the Senate Committee on Governmental Affairs, 2002: 13; Coffee, 2001 and 2002: 14-15; McEnroe and Martens, 2001).

The third and final major effect to arise from the evolution of audit firms into multi-disciplinary professional service firms involved a much broader transformation in the organisational culture of accounting firms (*Wall Street Journal*, 12 March 2002). This cultural transformation became most visibly apparent during the dot.com boom during the mid 1990s when accountants, traditionally a conservative profession, began to embrace the risk taking culture of the new economy and lobbied fiercely for changes in accounting rules to reflect, what they alleged, was the hidden value of new economy firms (Langewoort, 2002). But, according to Jeffery Gordon, the main cause of this cultural transformation has been audit firms' provision of tax advice. Tax planning, he argues, carried over into "accounting planning" – a process in which the accountant interprets accounting rules to maximise reported income irrespective of whether the corporation's fundamental value is misrepresented. Accounting rules, like the tax rules, in short, become the subject of professional manipulation. This, of course, was made possible by the trend towards more particularistic accounting standards. Moreover, because it meant that the process of auditing became regarded as a value-added service, rather than a statutorily imposed cost, it also blurred the boundaries between the audit and audited firm as accountants at once came to regard themselves and be regarded as part of the management team[6] - a process that further undermined the potential for adversarial audits (Gordon, 2002: 7-8).

Put simply, the business and regulatory environment in which auditors have come to operate in the US have served to compromise their independence and undermine both their capacity and motivation to uncover fraud or object to the management of corporate earnings. These effects are clearly observable in what occurred at Enron. Accounting rules for reporting Special Purpose Entities, for example, were mechanical and failed to reflect the real economics of Enron's transactions. Andersen's relationship with Enron also provides a convincing explanation for Andersen's multiple violation of GAAP. Its financial dependence on Enron business was considerable. In 2001 Andersen received just $25 million in audit fees from Enron. This contrasted with the $27 million it received for consulting fees. This not only made Enron Andersen's second largest client in the US, but it also underlies what was an intimate relationship. Andersen had designed Enron's internal compliance system. Auditors and consultants were permanently posted in Enron offices. Andersen also obtained $5.7 million for advice relating to Chewco and LJM-related transactions, which were at the centre of some of the main allegations of false accounting. Furthermore, senior Enron executives responsible for accounting had themselves been recruited from Andersen. It was not, however, simply the partners in Houston, where Enron was based, who were complicit in Enron's earnings management. Senior partners at Andersen's Chicago office were consulted on and approved many of Enron's off balance sheet transactions, noting, as they did, that fees from Enron could soon amount to $100 million a year. Andersen's motivations were clearly conflicted. When the credit risks at the special purpose entities became clear, requiring Enron to take a write-down, the auditors succumbed to pressure from Enron's management and permitted the company to defer recognizing the charges

(Bratton, 2002: 63-70; Healy and Palepu, 2002: 21-22; *Wall Street Journal*, 21 January 2002).

Whether, of course, the above, highly summarised arguments, explain the concentration of corporate frauds that have emerged over the last few years is ultimately an empirical question, the answer to which has yet to fully emerge. The available evidence, however, is highly suggestive. Not only does the evidence indicate that non-audit fees increase the incidence of earnings management (Frankel et al, 2002), not only does it suggest that the balance sheet has become increasingly disaggregated**,** but it also suggests that the transformation of audit firms into multi-disciplinary professional service firms is reflected in a massive increase in the number of earnings restatements by public companies in the 1980s and 1990s. From just 3 in 1981, these climbed steadily during the 1980s, averaged 49 *per year* between 1990 and 1997 and then, once after the SEC began to address the problem, increased to 91 in 1998, 150 in 1999, 156 in 2000 and 270 in 2001 (Huron Consulting Group, 2002; http://www.fei.org/download/QualFinRep-6-13-2k1.ppt.). Each year the amounts involved increased substantially, indicating that the large accounting firms had long been complicit in earnings management, particularly the premature recognition of revenue – which could no longer be sustained (Coffee, 2002: 8-9). The question, however, remains - why does such a poor media of control occupy such a central role in the general apparatus of fraud surveillance and detection?

The Triumph of Form over Content in US Corporate Governance

The first, and perhaps, the most important reason is that the system in the US - although complex, multi-layered and, in a sense, comprehensive - was almost designed to fail as it was, and continues to be, based on the idea of independent monitoring by directors, auditors and regulators who have poor and incomplete access to information and little motivation to scrutinize further (Ribstein, 2002). This, to a large extent, is as true for accounting as it is for other, less independent, services which ostensibly perform a role in financial regulation. Significantly, in the context of the present discussion, this is a product of how the system was originally designed (Staff to the Senate Committee on Governmental Affairs, 2002: 21). When the Securities Exchange Act of 1934 was originally introduced, Congress simply ignored the fact that the traditional client relationship between accountant and company implied that 'the accountant was a trusted and confidential advisor to the company only.' (O'Connor, 2002: 8) Independence, in other words, was, from the outset, simply a term applied to the nature of the new requirement of a statutory audit. The relational position of accountants relative to their clients, underpinned by the fact that the auditee paid the auditor, remained the same. Problems with audit firm independence and the failure to detect fraud have recurred ever since. The alleged fraud at Enron is not new, but simply a recent example of accounting manipulation that predates the current era of globalisation (ibid: 25; *The Washington Post*, 10 February 2002). What is important, in the context of this discussion, however, is that the compromised position of accountants, as well as their failure to detect fraud is, at least in part, a function of the historical development of financial regulation in the US and not easily explained in terms of the emergence of regulatory competition in a globalised economy. The question, however, remains – why has the state not intervened to rectify these problems?

To understand the answer to this question is it important first to realise that (unlike the case of environmental or health and safety legislation) competitive deregulation of accounting standards may benefit individual corporations in the short term but it does nothing to promote the interests of capital in general in the medium or long term. This is because, consistent and generally applicable accounting standards, introduced to offset the protective effects of limited liability, exist to promote the interests of institutional, corporate and individual investors. And where accounting standards do not appear to be either consistent or universally observed, and financial information is unreliable, the effect is a general sense of insecurity and decline in investor confidence. This is precisely what has happened in the US. One poll in July 2002, for example, reported that 73 *per cent* of a random sample of the public said that the practice of audits concealing information prejudicial to a company was widespread (*USA Today*, 10 July 2002). Similarly, an earlier poll found that 57 *per cent* of people did not trust corporate executives or brokerage firms to give them honest information and that a third thought that the events at Enron were typical of most or many corporations (*Wall Street Journal*, 13 June 2002.). That this loss of confidence has led to a decline in investment is less clear, not least because it is difficult to disentangle how much of the rise in share prices in the 1990s was due to fraud. The available evidence, however, suggests that the widespread fraud and false accounting has had a material impact on US stock markets and corporations, causing a decline in foreign investment in the US, losses of firm value, generally lower stock prices and a reduction in the supply of short-term credit (*Financial Times*, 27 June 2002; Eduardo et al, 2002; *The New York Times*, 4 August 2002; *Wall Street Journal*, 28 March 2002). There is, in short, no real economic value in ineffective financial regulation. Investment in the medium and long term gravitates to those companies with higher accounting standards where profits are predictable. It is, therefore, more plausible to understand why the state's failure to rectify the basic conflicts of interests that characterise US financial regulation first, in terms of the philosophy that underpins US financial regulation and second, in terms of the uneven corporate colonisation of US government.

The overarching philosophy that has traditionally underpinned financial regulation in the US is characterised by two main assumptions. The first is that direct state and federal regulation generally represents an unacceptable infringement on managerial autonomy. The second is that regulation, where possible, should facilitate the interests of US corporations. This is captured perfectly in Harvey Pitt's assertion, once he had taken control of the SEC, that the Commission would become 'a kinder and gentler place for accountants' (*The Guardian*, 7 November 2002). The fundamental problem with this approach in the context of financial regulation, a problem which Pitt's comments provide important clues to, is that the interests of US capital are not homogenous. A good example in the context of financial reporting is that auditors, who might want to use their flexibility and ability to obscure as a selling point, have different interests from fund managers, who value predictability and transparency. The important questions, of course, are which interests are prioritised and why. The best available answer, certainly in the context of the available evidence, seems to reside in the degenerate form that politics now takes in the US.

Put simply, the SEC's policy on auditing has been shaped by political lobbying which, in this context at least, seems to have developed in relative autonomy from the gradual integration of the world economy. At most this policy might be related to globalisation only in the sense that it has helped to create an environment in which such lobbying is accepted, but as a policy it is certainly not reducible to the processes of globalisation. US accounting firms have simply been very effective at ensuring that their interests are reflected in government policy and regulatory practice.

Despite the fact that, in the pre-Enron era, the SEC never successfully intervened to force audit firms to divest themselves of their consulting businesses, its senior management were aware that the conflicts of interest that accounting diversification implied were, at some level, implicated in earnings management (Levitt, 1998; Turner, 2002). This, as we saw above, had become a major problem that had become considerably worse during the 1990s in the wake of changes in the legal liability of accountants. These generally decreased the legal risks, and, therefore, costs, that accountants faced. Intensive lobbying of state legislatures, for instance, served to 'assure the passage of statutes recognizing the limited liability partnership' (Bratton, 2002: 70). More generally, a number of Supreme Court decisions, making it more difficult for private plaintiffs to seek legal address against accountants, the introduction of new legislation restricting class actions for fraud and a decline in enforcement action by the SEC in the 1980s (in part response to the fact that the consolidation of the accounting profession had meant that the large accounting firms had far greater resources to contest regulatory action), had served to reduce the risks of earnings management for accountants (Coffee, 2002: 12-14). As a result, the SEC did attempt to force a formal and complete separation of auditing and consulting. In the event, however, it was frustrated. Intensive lobbying by the large accounting firms in Washington forced the SEC to back down and a compromise was sought (*New York Times*, 18 January 2002; *New York Times*, 25 July 2002). As Levitt later put it: 'An extraordinary amount of political pressure was brought to bear on the Commission. We ended up with the best possible solution – given the realities of the time (Levitt, 2002: 76).' This process, in which political influence of corporations has imposed massive constraints on the SEC's attempts to control the accounting industry and, therefore, minimise the likelihood of systemic failure, became institutionalised when Harvey Pitt, a commercial lawyer who previously acted for the large accounting firms, took over the chair of the SEC (for examples of Pitt's defence of the accounting profession in the post Enron era see *Wall Street Journal*, 11 December, 2001).

There are other examples of the effectiveness of political lobbying by the accounting profession (*New York Times*, 24 July 2002). What is important, however, is that it is difficult to justify these compromises on the basis of allowing accountants to compete internationally or on the basis of ensuring that accountants did not relocate outside of the US. Accounting firms are already international and, as a service industry, cannot so easily be based beyond the legal jurisdiction and immediate location of the markets they service. Instead, it seems better to accept that corporations are not necessarily concerned with the efficient allocation of capital and that, ever since the creation of the SEC, some commercial organisations, in this case accountants, have successfully lobbied the state to limit independent oversight which might, otherwise, optimise the efficient allocation of capital. In short, auditing in the US fails, in part, because it was and continues to be based on a false premise, in part, because it is underpinned by a corrupting philosophy, and, in part, because, as a result of uneven political access, it has never been allowed to adapt to the transition of the accounting firm from an institution that once emphasised professionalism to one that now emphasizes the maximisation of profit.

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[2] The purpose of this was to present the loans as trading liabilities rather than debt and treat the cash received as cash flow form operations rather than cash flow from financing (Staff to the Senate Governmental Affairs Committee, 2002)

[3] For instance, Enron's 2000 Annual Report showed that it had both large investments and owed substantial liabilities to Enron related companies. Although these disclosures did not clarify that Enron's income essentially depended on derivatives trading and that Enron was not actually hedged, the disclosures could quite easily have been pursued and the relevant facts obtained. The imperative of this becomes even clearer considering that Enron's $90 share price in 2000 could only be justified by some very unrealistic assumptions, including an indefinite 25 *per cent* return on equity, revenues of $700 billion within the decade, and an annual increase thereafter of 10 *per cent*, more than twice the

historical average of listed US corporations (Healy and Palepu, 2002; Ribstein, 2002: 6; Bratton, 2002: 59-62).

[4] Securities Act 1933 and Securities Exchange Act 1934.

[5] *United States v Arthur Young & Co*., 465 U.S. 805, 817-818 (1984).

[6] In some cases accounting firms even began to market accounting products (similar to the Special Purpose Entities that Enron used to conceal debt) to inflate earnings. As William Bratton has observed, the more innovative and misrepresentative the accounting implicated in the products, the more important it is that the seller firm is also the auditor. This is because the "sales relationship imports a favourable audit". Bratton, 2002: 71.